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New Worries on Inflation and Homes

By Vikas Bajaj
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Houses are getting cheaper by the month. Everything else is becoming more expensive.

Several economic reports released on Tuesday provided fresh evidence that the economic pain of a prolonged slump in housing is being compounded by the rising cost of oil, food, clothes and other goods. Not surprisingly, a measure of consumer confidence fell to its lowest level in nearly five years.

In addition to squeezing American homeowners, the confluence of falling home prices and accelerating inflation is putting policy makers in an increasingly tough position. If they move aggressively to cut interest rates and stimulate the economy, they risk fueling inflation further at a time consumers are already strained. But if they fail to act boldly, the economy could weaken faster.

“The Fed is now having to walk a very fine line,” said Jane Caron, chief economic strategist at Dwight Asset Management, an investment firm that specializes in bonds. “We have clearly seen an acceleration in inflation pressure in the last couple of months and the risk is that the markets are going to react negatively to aggressive easing going forward.”

Nonetheless, the stock market rebounded from an early decline on Tuesday to close up for the day. The Standard & Poor’s 500-stock index rose 0.7 percent, to 1,381.29, and the Dow Jones industrial average was up 114.70 points, or 0.9 percent, to 12,684.92.

Energy and technology stocks led the market higher after oil prices surged above $100 again and I.B.M. announced that it would buy back $15 billion of its stock and raised its profit forecast.

In the bond market, investors snapped up inflation-protected Treasuries, indicating that they were worried about higher prices. The yield on the 10-year inflation-protected note, which moves in the opposite direction of its price, dropped to 1.407 percent from 1.507.

The dollar fell to $1.4967 against the euro, its lowest level since that currency was created. It was also trading near long-term lows against other major world currencies like the Canadian and Australian dollars.

A widely followed index of home prices in 20 metropolitan areas fell by 9.1 percent in December from the month a year ago. Using a three-month moving average, the index, the Standard & Poor’s Case-Shiller, is falling at an annual pace of more than 20 percent. The index tracks repeat sales of single-family homes; it does not include condominiums.

Another index of home prices that covers more of the country but does not track loans above $417,000 fell 0.3 percent in the fourth quarter from the period in 2006. The index, compiled by the Office of Federal Housing Enterprise Oversight, showed prices declining in all states, except Maine.

The Labor Department reported that wholesale prices, which exclude taxes and distribution costs, rose 1 percent in January, in contrast to a drop of 0.3 percent in December 2007. Compared with a year ago, prices were up 7.4 percent. Excluding food and energy prices, which are more volatile from month to month, the index increased 2.3 percent from a year ago, up from 2 percent in December.

The latest inflation report appears to corroborate a broader trend of higher prices.

Last week, the Labor Department reported that the Consumer Price Index rose 4.3 percent last month from a year ago, compared with a 4.1 percent increase in December. The core rate of inflation — which excludes food and energy — was 2.5 percent, up from 2.4 percent. The Fed’s target for inflation is 1 percent to 2 percent.

“The pressures are too great here,” said Seth B. Plunkett, a bond portfolio manager at American Century Investments, a mutual fund company. “Look at the things that are accelerating: food and energy. What is decelerating? It’s electronics and light trucks. These are not things that people buy every day.”

The drumbeat of negative economic data appears to be taking a toll on consumers — at least in the way they perceive the economy, if not in how they spend.

The Conference Board reported on Tuesday that its consumer confidence index fell to a reading of 75 this month, from 87.9 last month. The index was last at this level in early 2003, at the start of the war in Iraq and a time when the economy was growing but the unemployment rate was hovering just below 6 percent. By contrast, the unemployment rate was 4.9 percent in January.

“The reality is that the consumer is the driver for the U.S. economy,” said Edward E. Leamer, an economist at the University of California, Los Angeles. “Consumers are overspent and heavy in debt.”

The Fed cut its benchmark interest rate to 3 percent, from 5.25 percent in September, in an effort to offset the drag from the housing market on the broader economy. Its efforts have helped reduce some strains in the financial markets but they have been less successful in lowering borrowing costs and easing lending standards for businesses and consumers.

On Tuesday, the vice chairman of the Fed, Donald L. Kohn, said in a speech that at least some of the increase in borrowing costs was “a healthy correction to previous excesses.” He also asserted that the problems in housing and the financial system pose a greater threat to the economy than inflation.

“In my view, the adverse dynamics of the financial markets and the economy have presented the greater threat to economic welfare in the United States,” he said, according to his prepared remarks.

In the last several weeks, mortgage interest rates have risen sharply as bond investors have grown more risk-averse. The national average interest rate on a 30-year fixed-rate mortgage rose to 6.04 percent last week, according to Freddie Mac, from a low of 5.48 percent in mid-January when the Fed cut rates in between its regular meetings.

“The phone was ringing off the hook, everyone wanted to shop mortgages and rates,” D. Ritch Workman, president of the Florida Mortgage Brokers Association, said about the low rates. “By the time they got around to picking a lender it was too late and those rates were gone.”

Economists say home prices will remain under pressure for much of the next year or longer because the supply of homes for sale remains high. It has also become harder for home buyers to get mortgages as rates have risen and banks have become more conservative in demanding bigger down payments than they did during the housing boom.

In many parts of the country, specialists note that home prices remain too high based on affordability calculations made using incomes and interest rates. A recent report by analysts at Credit Suisse, the investment bank, said that prices in some metropolitan areas like Phoenix, Miami and Los Angeles would have to decline by 20 percent to 40 percent from their current levels for home affordability to be restored to its long-established level.

Mr. Leamer noted there was a silver lining to the steeper drop in home prices at the end of last year: it will eventually allow people who are currently renting to buy properties and help clear out the large number of homes that are on sale now.

“The question is, Are you going to get the bad news week after week for 10 years?” he asked. “Or are you going to get the bad news right this year and then you’ll learn to live with the reality that your home is not worth what it was?”